# BUSINESS BUDGETING PRINCIPLES AND PRACTICES: THEIR APPLICATION AND USE IN THE NAVY EXCHANGE SYSTEM

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TABLE OF CONTENTS

LIST OF ILLUSTRATIONS

LIST OF TABLES

# CHAPTER I

# INTRODUCTION

The Navy Exchange System is a retail business system organized and operated within the federal government for the primary purpose of promoting the morale of military personnel in the naval service. Since it is essentially a self-supporting business enterprise, it follows that it is expected to produce profits and therefore enjoys a degree of autonomy within the framework of government. The organization and operations of military exchanges are generally free from government regulatory procedures external to the system itself.

Budgetary control is a common practice of most successful business enterprises. Through its widespread use, business budgeting has developed certain methods and procedures which have come to be regarded as principles or policies by executives in the business world. The application and use of business budgeting practices in the Navy Exchange System is the subject of this thesis.

## Purpose of the Study

The purpose of this study is: (1) to determine if and to what extent the Navy Exchange System applies and uses in its operations the most commonly accepted practices and principles of business budgeting, (2) to identify the areas wherein the Navy Exchange System requires special procedures not common

to private retail organizations, and (3) to reach conclusions that will lead to recommendations for improving budgetary control in the Navy Exchange System.

Scope of the Study

The Navy Resale System, as differentiated from the Navy Exchange System, includes a world-wide network of navy exchanges, commissary stores, ship's stores afloat, and naval uniform shops. This study is limited to the Navy Exchange System within the Navy Resale System; thus, the limits will be defined by those functions of the Navy Ship's Stores Office (the central controlling office of the Navy Resale System) which pertain to the Navy Exchange System and the navy exchanges which are the operating departments of the Navy Exchange System.

In making a study of any business organization, it seems essential that it should be examined in the light of its operating environment. The operating climate of a business enterprise is determined essentially by its ability to satisfy its consumers' needs and public acceptance of the methods the organization uses to develop this ability--one of the most conclusive examples of the power of public acceptance is the dissection of the Standard Oil Company empire after the enactment of the Sherman Anti-Trust Act. Therefore, while this is not intended to be a historical study of military exchanges or the public attitude toward business enterprises in government, a brief discussion of these aspects is pertinent.

In line with the purpose of this study, a review of the business literature published in the past decade which relates to activities of managers indicates a general agreement among business executives and scholars

of the subject as to the importance of the planning and control function of management. Today, there is no doubt concerning the need for efficient planning and control of business operations to achieve effective coordination of human and material resources.[1] Budgetary control programs have become a scientific management technique used by many business organizations in order to deal adequately with all the details connected with the development of plans and control of operations. One writer has defined a budget as a plan of operations stated in figures, a constant look at the future, and an indispensible preliminary to control.[2]

It is this budgetary concept of planning and control which will define the limits of this study. The method and means of translating plans and operations into financial data and the use of this data for control in the Navy Exchange System will provide the direction for this study.

As stated above, some knowledge of the environment of the Navy Exchange System is pertinent to this study; therefore, Chapter II will provide a historical outline of the need for military exchanges and the public attitude toward military exchanges. Since some knowledge of the organization and functions of the various management levels in the Navy Exchange System is fundamental to this study, Chapter III contains a statement of the objectives of the system, describes the organizational structure, and provides some insight into the functions of management at various organizational levels. Chapters IV and V outline some of the more commonly accepted principles and procedures relating to business planning and control problems. The elements

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[1] Burnurd H. Sord and Glenn A. Welsch, Business Budgeting: A Survey of Management Planning and Control (New York: Controllership Foundation, Inc., 1958), p.1.

[2] James L. Pierce, "Control by Budget," The Controller, Vol. XXV, No. 7 (July 1957), p.327.

of planning and control within the Navy Exchange System are reviewed in these chapters to determine to what extent its policies and procedures adhere to those advanced by scholars and business executives. Chapter VI contains the conclusions of this study.

# CHAPTER II

## OPERATING ENVIRONMENT OF THE NAVY EXCHANGE SYSTEM

### The Need for a Retail System in the Navy

The sale of items to satisfy the common needs of military personnel can be traced back to the time of Caesar in ancient Rome. Tiny shops located along the Via Quintana catered to the needs of Caesar's legionnaires and provided them with items not issued by their quartermaster. It is believed that the term "canteen," which is frequently used to describe all sales activities for military personnel, is derived from the Latin word "quintana."[1]

This specialized field of trade with military personnel in America has been traced back to the Army of 1776. Certain rules for the control of Sutlers were established in Section VIII, American Articles of War of 1776, which were enacted September 20, 1776. Sutlers were peddlers who followed the Army for the purpose of selling food and other supplies to the soldiers.[2]

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[1] U.S., Department of the Navy, United States Naval Administration in World War II, Bureau of Supplies and Accounts, Vol, XVI, p.1, cited by Harry Everett Gavey, "Supply Management in the Navy Resale System Afloat," (unpublished paper presented to the Chief of Naval Personnel, Department of the Navy, Washington, D.C., December, 1956), p.1.

[2] U.S., Department of the Army, "Sutler Information for General Young," prepared by the Office, Deputy Chief of Staff for Personnel, Department of the Army (in the files of the Deputy Chief of Staff for Personnel, Department of the Army, Washington, D.C.), p.3, cited by Robert H. MacPherson, "Adherence to Management Principles in the Administration of the Army and Air Force Exchange Service" (unpublished Master's thesis, School of Government, The George Washington University, June, 1959), p.8.

The Sutlers were replaced by post traders. These were private individuals or groups who were authorized by Congress in 1867 to set up their stores on military posts to sell convenience items which were not provided to the troops by their quartermasters.[3] As a result of unethical practices and exhorbitant charges of the post traders and Sutlers, "canteens" were formed on many military posts by military personnel as cooperative ventures. The canteens sold at cost items of common necessity and use to members. If profits were generated, they were paid to a general recreation fund. The Army officially recognized these canteens in 1889.[4] Congress recognized them in 1892 when public buildings were authorized to be used for canteen purposes.[5] Congress in 1893 abolished post traders because lack of control over this system of servicing military personnel permitted and encouraged the development of unethical business practices to take advantage of the individual serviceman and his family at remote posts.[6]

Afloat, the naval service had its corallary to the Sutlers and post traders in the "bumboaters." Bumboaters were peddlers who operated in shabby boats alongside ships in port. Sales were usually transacted by sailors placing their money in a bucket and lowering it over the side to the bumboater, who in turn, filled the bucket with the desired articles. The bumboaters supplied the sailors with personal items which were not provided to them by the government, such as toiletries, tobacco, candy, soap, and various

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[3]U.S., Headquarters, Army and Air Force Exchange Service, Fact Sheet on Army and Air Force Exchange Service (New York, undated), p.2.

[4]U.S., Department of the Army, General Order No. 10, The Adjutant General's Office, February 1, 1889.

[5]U.S., "Fact Sheet on Army and Air Force Exchange Service," undated.

[6]U.S., Statutes at Large, Vol. XXVII, p.426.

knicknacks. Until comparatively recent times, these traders carried on a thriving business with ships of the fleet. Some bumboat men followed individual ships from port to port, and occasionally they were even carried on board naval vessels. Practically every ship had a regular bumboat man who was given a virtual monopoly on that ship. Like their counterparts ashore, they generally sold merchandise of poor quality and charged exhorbitant prices. In addition, their presence on board ships frequently became a nuisance, especially since many served as a source for illegal or contraband articles.[7]

These practices led to the formation of unofficial ship's stores and canteens, which, like the army canteens, were financed by crew members. The first ship's canteen was organized in 1896 on board the U.S.S. Indiana. The canteen sold only beer and used the profits to buy additional food for the crew's mess.[8] However, canteens flourished not so much on the sale of beer as on such personal items such as candy, tobacco, soap, and writing materials, as these enterprises began to become an integral part of life at sea.

Since these canteens were operated informally and with little responsibility or accountability, some individuals were encouraged to use this opportunity for their personal advantage and thus bring discredit upon the Navy. Some of the civilian suppliers of these canteens found they had no recourse to the government when bills were unpaid, and the lack of official controls made this system ripe for fraud and other defalcations.

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[7] Julius A. Furer, Administration of the Navy in World War II (Washington, D.C.: Navy Department, 1959), pp. 456-457.

[8] B.C. Decker, "The Consolidated Mess of the Crew of the U.S.S. Indiana," Proceedings of the U.S. Naval Institute, Vol. XXIII, No. 9 (September 1897), p. 465.

These problems received their initial official recognition in the Navy Appropriations Act of 1908, which provided for the procurement and sale of articles to naval personnel as authorized by the Secretary of the Navy.[9]

In July 1915, the Navy Department issued regulations prescribing exactly what items were to be stocked and what the selling prices of these items were to be.[10] Profits from sales in the ship's stores were set aside in a fund to be used for the recreation of the crew.

The expansion of the armed forces through two world wars, a rapidly improving standard of living, and the higher educational level of the average serviceman have made demands on the military resale system leading to their growth commensurate with the retail industry in America. Expansion of the system and growth in the individual exchanges brought requirements for more organization and stronger central controls for the purposes of uniformity and efficiency.

In a report on the armed services exchanges, the Subcommittee on Defense Activities of the House Armed Services Committee made the following statement in 1953:

> We believe that if the serviceman and woman are expected to pay the same prices as civilians for everything they require, the implementation of any such action should be contemporaneous with an appropriate pay readjustment. Then there could be no problem. But servicemen and women should not be asked to bear all the burden with none of the benefits.
>
> The post exchange is the enlisted man and woman's club. Many times it is the only thing that stands between them and almost complete stagnation. Servicemen and women are shifted from place to place as the needs of training and deployment for military advantage require. They are captives of the Government as to place and duty during the periods of their service. They have no opportunity to integrate themselves with local communities. They have no way of determining the

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[9] Gavey, pp. 6-8.

[10] U.S., Navy Department, Annual Reports, Bureau of Supplies and Accounts, 1916, p. 360.

integrity of the businessman at their gates or in cities nearby military establishments. The same Government that provides medical care and is charged with protecting his morales, owes the further duty of assuring him that he will not be mulcted of his small pay by unscrupulous characters who, in the past, have preyed upon them.

Let it be kept clearly in mind that we owe the serviceman or woman the duty of providing them with the decencies of life and living not only when we are scared to death and at war, but, well, as when we are merely preparing against those days of uncertainty.

A greater part of the patrons of exchanges are young and inexperienced. Most of them are away from home for the first time. They are in no position to drive shrewd bargains: nor have they the money with which to do it.

Neither ought we forget that these patrons of the exchange are the beneficiaries of the exchange. Military personnel away from home are also taxpapers. What is more important: they are the sons and the daughters of American taxpayers.[11]

More recently a journalist, in commenting on the Navy Exchange System, remarked:

But it ain't like Macy's nor Gimbels . . . . For if a Macy customer doesn't find what he wants he can walk across New York's 34th Street into Gimbels. To Naval personnel there is no across the street. Most Naval families are utterly dependent on their stores for everyday necessities and for savings that stretch already-thin pay checks.[12]

Perhaps more important than all of these reasons for a Navy Exchange System is that the navy exchange can provide an escape from loneliness. In the exchange, the individual serviceman sees items that he has become familiar with in civilian life. Whether or not he buys them, he can see these products and this provides him with a touch of what was once his normal way of life. This is especially important to men at sea and remote overseas bases; however, some individuals can be as isolated at a Naval Receiving Station in Boston or New York as they would be on Midway Island

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[11]U.S., Congress, House, Subcommittee on Defense Activities of the Committee on Armed Services, Report on Armed Services Exchanges (PX's), 1953, 83rd Congress, 1953, pp. 9-10.

[12]John J. Ryan, "Your Navy Exchange System," Navy Times, September 7, 1957.

or Adak, Alaska. Further, the navy exchange may be one of the few places on a military reservation where the individual can express his individuality by choosing what he wants: no one orders him to buy a certain item or brand; a seaman's dollar is worth just as much as an admiral's dollar. He doesn't stand in line and his demands have the same impact on the exchange operations as do the customers' of a civilian retail organization.

## Public Attitude Toward Business in Government

There seems to be a general attitude among American taxpayers that business organizations in the government are needless duplications of private industries and that these organizations are administered poorly and are less efficient than private business organizations. During the past decade the chief executives of some of America's largest and best managed business organizations have entered the federal service with the objective of effecting widespread economies and injecting efficiency in government operations.

The first Hoover Commission concluded that there was colossal waste, duplication, extravagance, and inefficiency right through the federal government.[13] In the field of government business enterprises, the commission found a confusion of effort and duplication of functions, archaic accounting procedures, and other organization deficiencies.[14]

The second Hoover Commission again critized government business enterprises. In its preface to the report on business enterprises, the

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[13]Neil MacNeil and Harold W. Metz, The Hoover Report 1953-1955: What It Means To You as Citizen and Taxpayer (New York: The Macmillan Company, 1956), p. 15.

[14]Frank Gervasi, Big Government: The Meaning and Purpose of The Hoover Commission Report (New York: McGraw-Hill Book Company. Inc., 1949), p. 144.

commission said:

> The genius of the private enterprise system is that it generates initiative, ingenuity, inventiveness, and unparalleled productivity. With the normal rigidities that are part of Government, obviously, the same forces that produce excellent results in private industry do not develop to the same degree in Government business enterprises.[15]

The armed services exchanges have not been specifically excepted from these searing statements of inefficiency and waste in government business enterprises, nor have they been immune from pressures of the various trade and professional organizations which constantly lobby Congress to eliminate government business enterprises as a source of competition to their individual industries. In 1949, the Philbin Subcommittee of the House Armed Forces Committee had as one of its findings, the following:

> The committee has come to the conclusion that the Armed Forces are actively competing with established private business. In accordance with current regulations, a very wide range of merchandise is being sold through post exchanges and ships' service stores and much of it duplicates merchandise being sold by retail-businessmen within the same general area.[16]

On the other hand, the Subcommittee on Defense Activities, in 1953, found that the exchanges employed an adequate and satisfactory method of audit; that audits were performed by independent and responsible firms; and, that there was no justification for any complaint about the alleged lack of business management or business records.[17] The inquiry of the armed service exchange operations by this subcommittee was prompted by a series of charges and conclusions presented by the American Retail Federation.

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[15]MacNeil and Metz, p. 15.

[16]U.S., Report on Armed Services Exchanges (PX's), 1953, p. 10.

[17]Ibid., p. 3.

News commentators and analysts are quick to publicize isolated examples of inefficiency and waste in government business enterprises. While the armed service exchanges get their share of unfavorable publicity through our normal news media, it seems that the exchanges prudently avoid publicity relating to growth and examples of highly successful operations because such publicity would only intensify the already powerful lobbying forces directed at Congress. It is simply a case of "no news is good news" so far as the exchanges are concerned.

In light of the above statements, it is concluded that the public attitude toward business enterprises in government is not favorable and that the widespread belief among American taxpayers is that government business enterprises are not managed as effectively as private business enterprises.

## CHAPTER III

## THE NAVY EXCHANGE SYSTEM

### Objectives

A business enterprise must have two major objectives if it is to endure. First, there must be the profit objective and second, an objective of satisfying customers' needs and desires.[1]

The objectives of the Navy Exchange System are stated in clear and concise terms as the prescribed mission for each navy exchange:

> The mission of an Exchange is to provide a convenient and reliable source from which authorized patrons may obtain, at the lowest practicable cost, articles and services required for their well-being and contentment; to provide through profits, a source of funds to be used for the welfare and recreation of naval personnel; and to promote the morale of the command in which it is established through the operation of a well-managed, attractive, and serviceable Exchange.[2]

These objectives are worthy and attainable; they provide for constant effort to provide better service to naval personnel and to increase the efficiency of this service. The element of profit in these objectives provides the means of measuring performance which is traditional to the American way of business life. Profits combined with sales volume provides

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[1] Richard N. Owens, Introduction to Business Policy (Homewood, Illinois: Richard D. Irwin, Inc. 1954), p. 14.

[2] U.S., Navy Department, Bureau of Supplies and Accounts, Navy Exchange Manual, Para. 1311.

a means of measuring not only the efficiency with which the service is rendered but also measures the amount of service provided to naval personnel.

These objectives are published not only as a guide to top management and middle management of the Navy Exchange System, but are also a part of the indoctrination of new employees and are posted conspicuously in each navy exchange retail store and many service outlets. Thus, the objectives of the Navy Exchange System are not "ivory tower" ideals to be preserved as privileged information for the upper strata of management, but they are made known to employees and patrons, giving all the opportunity to know the ultimate ends of their contributions whether it is their work or their patronage.

## Organization

The importance of a clean-cut and sound plan of organization in facilitating and contributing to the effectiveness of administrating the business enterprise can hardly be over-emphasized. A good plan of organization delineates responsibility for performance of specific functions; it places authority commensurate with responsibility; it provides for the accomplishment of all the functions necessary to realize the objectives of the enterprise; it will preclude overlaps of functional responsibility and duplication of effort; it will also provide for channels of communication within the organization.[3]

Holden, Fish, and Smith divide top-management into three distinct and separable zones. These zones differ as to function, and to viewpoint, requisite background, and experience of the responsible personnel. They characterize these three zones as follows:

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[3] A. Rex Johnson, "Some Basic Concepts in Budgeting," Navy Comptroller Review, Vol. IV, No. 2 (February, 1957), p. 12 .

A. The Trusteeship Zone whose function is to represent, safeguard and further the stockholders' interests, determines the basic policies and the general course of business, appraises the adequacy of over-all results, and in general protects and makes the most effective use of the organization's assets. This zone is the exclusive province of the board of directors.

B. The General Management Zone has the function of active planning, direction, coordination, and control of the business as a whole, within the scope of basic policies established and authority delegated by the board of directors. This function involves the determination of objectives, of operating policies, and of results.

C. The Divisional or Departmental-Management Zone function includes the management of the major divisions or departments of the company by the executives fully responsible and accountable to general management for the successful conduct of their respective operations.[4]

A budgetary control system cannot thrive without a clear-cut organizational structure. Each unit should have a responsible manager, vested with authority commensurate with his responsibilities. The manager should have a clear understanding both as to the individual to whom he reports and to the people reporting to him. These are well-known principles of organization and the success of budgetary control will be marked by the degree of organization soundness.[5] Therefore, a look at the organization of the Navy Exchange System will have more than academic significance to this study.

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[4] Paul E. Holden, Lounsberry S. Fish, and Hubert L. Smith, Top-Management Organization and Control (New York: McGraw-Hill Book Co., Inc., 1951), pp. 15-16.

[5] James L. Pierce, "The Budget Comes of Age," Harvard Business Review, Vol. XXXII, No. 3 (May-June 1954), pp. 58-66.

In the Navy Exchange System the functions of the three zones of top-management as provided by Holden, Fish, and Smith are carried out by (1) an Advisory Committee, (2) the Chief, Bureau of Supplies and Accounts and the Commanding Officer, U.S. Navy Ship's Store Office, and (3) the Divisional Directors of the Navy Ship's Store Office and the Navy Exchange Officers who have charge of the operating departments.

## The Advisory Committee

In April 1946, the Assistant Secretary of the Navy (Material), established a committee known as the Navy Ship's Store Office Advisory Committee. Composed of military and civilian leaders in the field of retailing, finance, management, and education, the committee meets semiannually to render advice on matters pertaining to organization, policy, and operations of the Navy Ship's Store Office and all activities under its management and technical control.[6]

Traditionally, the "inside" membership of this committee has included the Assistant Secretary of the Navy (Material); the Chief, Bureau of Supplies and Accounts; Deputy Chief, Bureau of Naval Personnel; the Commanding Officer, Navy Ship's Store Office. The civilian, or "outside" membership has included such prominent men as Mr. W.H. Bingham, President, R.H. Macy and Company; Mr. R.M. Paget of Cresap, McCormick and Paget, a management consulting firm with a strong reputation in the retailing industry; Mr. H.S. White of Kuhn, Loeb and Company, investment bankers; Professor

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[6] U.S., Navy Ship's Store Office, Navy Resale System: Consolidated Report 1955, p. 29.

D.E. Faville of the Graduate School of Business, Stanford University; and Mr. C.H. Kellstadt, President, Sears, Roebuck and Company.[7]

Even though this committee was established to render advice rather than direct and does not have the formal authority vested in a board of directors, there can be little doubt that its recommendations carry as much respect as any decision made by a strong board of directors. If membership on the committee of an Assistant Secretary of the Navy and Chief, Bureau of Supplies and Accounts is not sufficient evidence of the committee's prestige and indirect power, certainly the willingness of some of America's most prominent business leaders to continue their membership on the committee year after year would attest that their recommendations constitute more than an academic drill.

## Commanding Officer, Navy Ship's Store Office

The Chief, Bureau of Supplies and Accounts has delegated his responsibility for and authority over the operations of the navy exchanges to the Commanding Officer, U.S. Navy Ship's Store Office. The management and technical control over operations of the navy exchanges is also so delegated by the Chief, Bureau of Supplies and Accounts. The Commanding Officer, Navy Ship's Store Office, is further directed to exercise his management and technical control through the commanding officers of the activities at which navy exchanges are operated.[8] Thus, it can be seen

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[7] U.S., Navy Ship's Store Office, Navy Exchange Review, Vol. XIV, No. 7 (July 1960), p. 2.

[8] Navy Exchange Manual, para. 1101-1103.

that the Navy Exchange System is organized to provide centralized control and decentralized operations.

The functions of the Navy Ship's Store Office may be divided into two classifications: (1) those relating to exercise of control, and (2) those relating to the provision of services. The operational functions of the Navy Exchange System are carried out at the navy exchange level.

Control by the Navy Ship's Store Office involves the development and promulgation of operating policies and procedures and the exercise of supervision over navy exchanges in the execution of these policies and procedures. The control functions include:

1. Developing and prescribing merchandising and operating standards for navy exchanges, reviewing performance of individual exchanges in relation to standards, and initiating corrective action as necessary.

2. Prescribing standardized accounting methods and procedures.

3. Exercising inventory control as necessary.

4. Establishes and administers procurement policies.

5. Prescribing standard mark-ups on all merchandise sold and for services provided by the navy exchanges.

6. Inspecting or auditing navy exchanges on a regular periodic basis to insure compliance with policies, directives, and procedures prescribed by the Navy Ship's Store Office, Bureau of Supplies and Accounts and other higher authority.

7. Developing and prescribing uniform personnel policies and procedures for the Navy Exchange System.

The service functions of the Navy Ship's Store Office include:

1. Maintaining the accounts of the individual navy exchanges and preparing monthly operating statements.

2. Negotiating and preparing open-end contracts with manufacturers and distributors for use of navy exchange officers in procuring merchandise and supplies.

3. Procuring and financing from its reserve funds all major equipment for navy exchanges such as cash registers, labor saving devices, automotive equipment, display equipment, etc.

4. Providing from its reserved funds insurance for navy exchanges, including employee fidelity bonding.

5. Arranging for an annual independent financial audit of the Navy Exchange System by a certified public accounting firm.

6. Providing operating capital for new and existing navy exchanges.

7. Providing standardized forms for use in navy exchange operations.

8. Maintaining staff of personnel qualified in commercial merchandising techniques and service department operations to assist navy exchange officers in improving operations and correcting unsatisfactory conditions as necessary.

9. Developing plans for the arrangement and layout of navy exchange stores and service facilities.

10. Conducting training program for officers and enlisted personnel assigned to duty in the Navy Exchange System.[9]

To perform these functions, the commanding officer is assisted by

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[9] Ibid., para. 1201 ff.

an executive officer and an organization divided into eight major divisions and an office manager, each headed by a director as follows:

1. Field Services - - this division performs management analyses of individual exchanges which includes review of operating statements, advisory visits, assistance in conducting surveys (inspections), preparation of survey reports, follow-up of survey recommendations, reviews military personnel allowances, prepares statistical reports on a sales volume basis, and maintains inventory shortage control.

2. Retail Merchandise - - this division guides the over-all retail operations of the system and the individual exchanges. The functions of this division are divided among four branches specializing in merchandise departments such as tobacco products, durables, notions and sundries, and clothing. In addition, these branches guide the retail operations of and maintain liaison with designated exchanges which have been grouped together in four geographical areas.

3. Services Merchandise - - this division guides the service operations of the system and the individual exchanges. Its branches specialize in service station operations, laundry services, food services, vending machine operations, etc.

4. Controller - - this division is responsible for the financial planning and control of the system; it maintains the accounts and prepares financial reports. Electronic data processing for the system is also the function of the Controller.

5. Industrial Relations - - the functions of this division pertain to civilian personnel matters.

6. Planning - - this division makes feasibility studies for special projects, such as electronic data processing systems, and handles problems in the field which pertain to these projects. The functions of this division relate primarily to procedural and systems plans. At present, its functions do not relate to financial aspects of planning; however, in the future it will become involved in establishing and measuring standards for the system.

7. Training - - this division conducts training courses for military and civilian personnel.

8. Store Layout and Display - - this division approves store plans, makes recommendations for layout and displays, and procures all equipment for the exchanges.

9. Office Manager, Navy Ship's Store Office - - this manager's duties relate to internal matters of the central office.[10]

A comparison of the control and service functions of the Navy Ship's Store Office and the functions outlined under the various division directors indicates a functional organization structure adapted to meet the needs of the system.

## Navy Exchanges

The Navy Ship's Store Office does not, itself, sell anything, nor does it generally procure or stock merchandise for resale. The operational functions of the Navy Exchange System are vested in the individual navy exchanges. It is the navy exchange officer who does the actual procurement, stocking, and selling of merchandise and services. The navy exchange officer

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[10] U.S., Navy Ship's Store Office, Navy Exchange Review, Vol. XIII, No. 11 (November 1960), p. 6.

A location exchange is operated as a part of a main exchange or branch exchange located in another command. The principal differences between the branch and location exchanges are that separate financial operating statements are not prepared for the location exchanges and therefore profits from operations are not paid directly to the command at which the location exchange is located. In size and scope of services, location exchanges are usually smaller than a branch or main exchange. Normally, all merchandise, supplies, and operating instructions are supplied by the main exchange.

Navy exchanges are further classified by groups on the basis of average monthly sales volume. There are five groups ranging from a Group I exchange, which has an average monthly sales volume under $10,000, to a Group V exchange having an average monthly sales volume of $150,001 or more.[12] This classification is made in order to develop operating standards and to make comparative evaluations of the individual exchanges within these classifications.

The basic organization of navy exchanges, as provided by the Navy Exchange Manual in paragraph 1313, are shown in Figures 1 and 2. The "H-9" is the retail department and the service departments, which are independent of each other, may include barber shops, cobbler shops, service stations, laundries, dry cleaning plants, cafeterias, enlisted men's and petty officers' clubs, photography studio, watch repair, personal services, and vending and amusement machines.

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[12]Ibid., para. 1312.

is responsible for the performance of these operational functions in accordance with the policies and procedures established and promulgated by the Navy Ship's Store Office. He is responsible to the Navy Ship's Store Office for operational matters pertaining to management and technical control through the commanding officer of the activity at which the navy exchange is located. Since the navy exchange officer is primarily a military officer, he is responsible only to his commanding officer for matters pertaining to military command.[11]

In order to understand the organizational structure of the individual navy exchange, it is necessary to have some knowledge of their classifications. The Navy Exchange System requires three types of exchanges. The mission and service provided by these types of exchanges are identical and all exchanges are operated as separate departments within the command activity at which they are located.

A main exchange normally performs within its own organization the functions of procuring, warehousing, accounting, and selling. It may also perform the procuring, accounting, and warehousing functions for the other two types of exchanges.

A branch exchange is operated as a branch of a main exchange at another command activity. It is, in essence, a selling unit of the main exchange located at another command. The main exchange provides procurement, warehousing, and accounting service for the branch exchanges. The operating instructions for the branch exchange are also provided by the main exchange.

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[11] Navy Exchange Manual, para. 1104.

Fig. 1. - - Basic organization chart of a main navy exchange with a branch and a location exchange

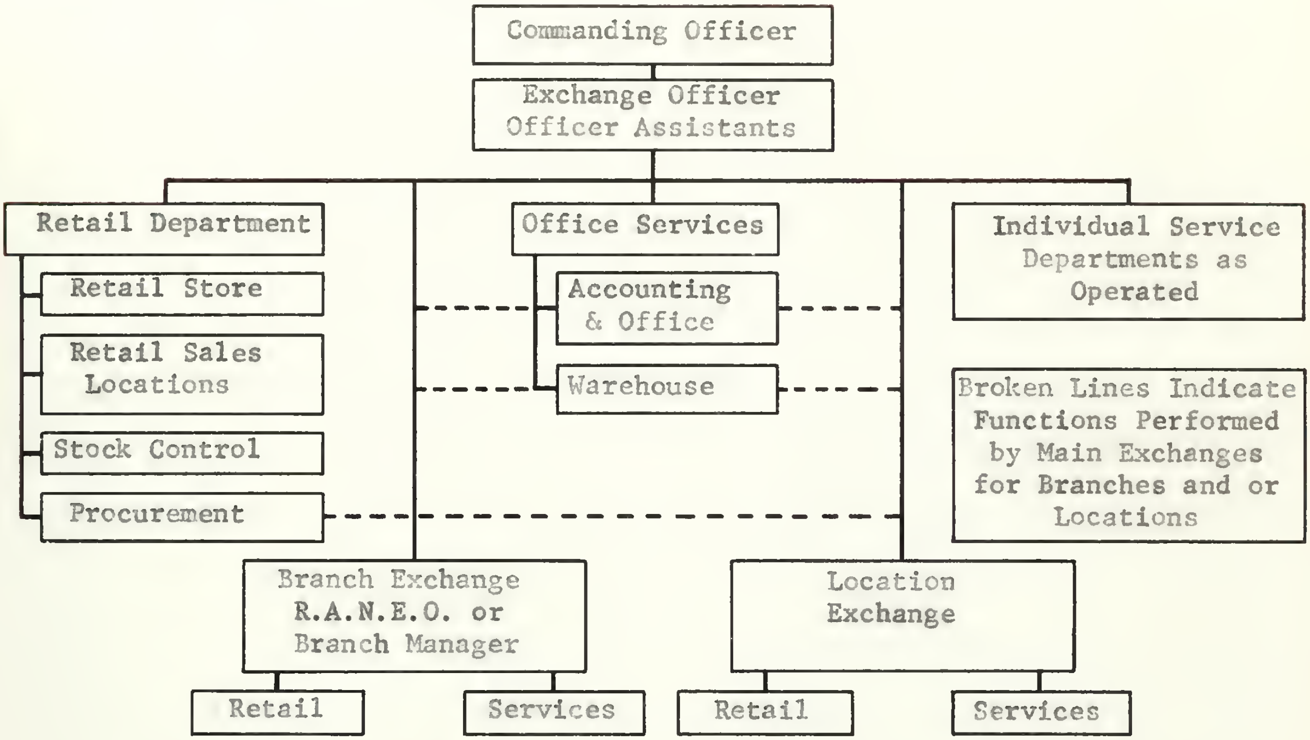
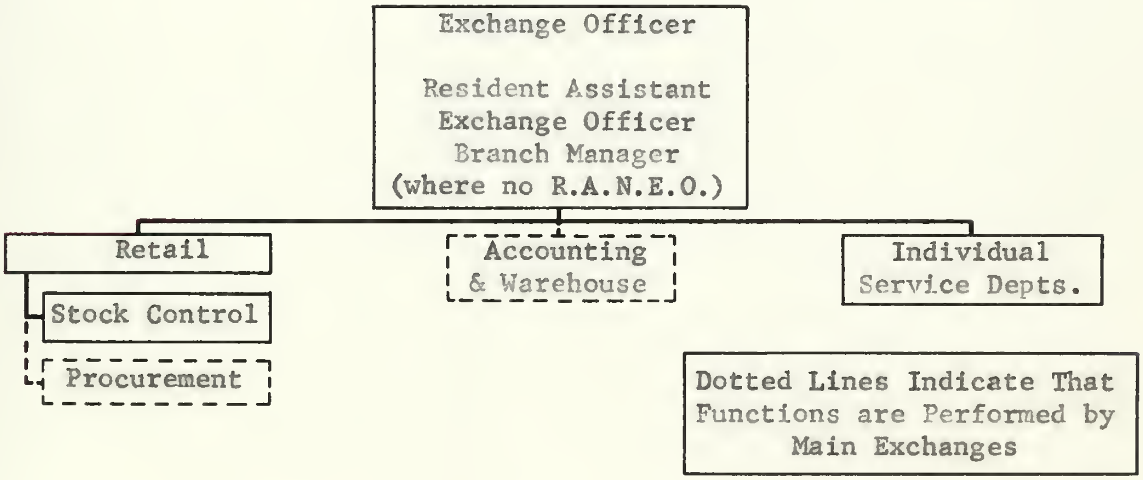



Fig. 2. - - Basic organization chart of a branch exchange



Some of the latest statistics pertaining to the Navy Exchange System which have been published indicate that the Navy Exchange System performs quite well in comparison to department stores. The navy exchange payroll for fiscal year 1956 was 14.4 per cent of sales while department stores were between 18 and 19 per cent; the world-wide stock turn was 5.4 for the year while the several hundred largest department stores had only 4.1 merchandise turns. In the period from 1948 to 1956, sales volume just about doubled and a total of $16,250,000 was contributed to welfare and recreation funds by navy resale activities in the fiscal year 1956.[13] While statistics of the Navy Exchange System performance during the years subsequent to 1956 are not generally available for publication, there has been progressive improvement each year in the system as reflected by operating statistics contained in reports on file in the Navy Ship's Store Office.

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[13]Ryan, "Your Navy Exchange System," Navy Times, September 7, 1957.

# CHAPTER IV

# PLANNING IN THE BUDGETARY CONTROL PROCESS

## Establishing Objectives

The goal of an organization is its objective. The basic plan of an organization is developed to accomplish its objective. Establishing organization objectives can be a complex problem. In the United States it is a common understanding that all business enterprises have one and the same objective -- to make a profit. This objective may be camouflaged by any number of platitudinous statements, such as service to the public or providing employee job security. It is not denied that these can be objectives of a business enterprise; however, a realistic analysis of these objectives indicate that they are subsidiary objectives which contribute toward the attainment of the primary objective of profit making. There is little likelihood that profits will generate from the production of some service or product which the public does not want or at price greater than the public is willing to pay. Security and status of employees are provided most effectively through a financially sound enterprise.[1] Profit is the financial nourishment necessary for maintaining the life and growth of any business enterprise.

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[1]Harold Koontz and Cyril O'Donnell, Principles of Management (New York: McGraw-Hill Book Co., Inc., 1955), pp. 430-431.

A business can have other objectives, such as surpassing competitors in sales or production, developing new products, attaining power or position, or just growth for its own sake. These objectives too will have profit making as their ultimate objective or else be dependent on making a profit to accomplish the objective. Thus profit is one objective which will be common to every business enterprise regardless of size or the nature of its products or services.

Emphasizing profit as the one right objective, however, can misdirect managers to the point where they may endanger the survival of the business. They may achieve profit today at the sacrifice of future profits. Promotion, research, new markets, and capital investment may be avoided to maximize current profits thus failing to provide the base for future profits. Managing a business is balancing a variety of needs and goals. Thus, by its very nature, a business enterprise requires multiple objectives.[2] Emphasis on certain objectives can and usually will vary during the life of business enterprise.

It seems elementary to mention that without objectives plans would be nonexistent and there would be no purpose to organize the activities or the human effort expended in a business enterprise. Peter F. Drucker has emphasized the importance of objectives by stating:

> Objectives in the key areas are the "instrument panel" necessary to pilot the business enterprise. Without them management flies by the "seat of its pants" -- without landmarks to steer by, without maps and without having flown the route before.[3]

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[2]Peter F. Drucker, The Practice of Management (New York: Harper and Brothers Publishers, 1954), pp. 62-63.

[3]*Ibid*., p. 87.

Drucker has also written: "Objectives are needed in every area where performance and results directly and vitally affect the survival and prosperity of the business."[4]

Thus it follows that in the area of budgetary control, clearly defined objectives are required for effective planning. Maintaining a cash position, getting a standard number of inventory turns, reducing costs, desired return on invested capital, and sales volume are but a few of the objectives that must be considered in the planning phase of budgetary control.

## The Profit Objective in the Navy Exchange System

The mission of the Navy Exchange System, as stated in Chapter II, emphasizes three primary objectives: (1) to provide a convenient and reliable source of goods and services for naval personnel, (2) to provide a source of welfare and recreation funds for naval activities through profits, and (3) to promote the morale of naval personnel. Congress has not accepted the philosophy of the profit objective among the primary objectives and considers the generation of profits only as a collateral objective.[5] The purpose of this study is not to debate the pros and cons of this issue, but to establish that the profit objective is a necessary element of the Navy Exchange System and to examine the role of budgetary control in the pursuit of this objective.

While sales volume is a measure of the amount of service provided by the Navy Exchange System, profit is a primary measure of over-all

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[4] Ibid., p. 63.

[5] U.S., Congress, Report on Armed Services Exchanges (PX's) 1953, p. 9.

with or without disciplined efforts to conform to the plan or account for deviations from it. On the other hand, control cannot exist without planning, and therefore planning should be designed to fit the specifications of control.[6]

Planning must be examined on the basis of what is happening, in effect, day-by-day, and the plans must be changed if conditions warrant a change or modification. Planning aims to achieve maximum coordination, and as the plans are executed the control mechanism records the results of action taken and feeds this information to management so that further planning can be done to improve performance. With a properly functioning control system, management is constantly receiving current information useful in further planning.[7]

Planning involves the selection, from among alternatives, of organization objectives, policies, procedures, and programs. Since control is the function of directing events to conform to plans, it follows that control is peculiarly dependent upon planning. Management cannot determine whether its organization is accomplishing its objectives unless it has planned a projected course of action -- a plan against which to measure progress or the lack of it. Plans may be identified by a variety of types -- selection of objectives, development of policies and procedures, programming, and the making of a budget -- each of these are decision-making processes affecting the future course of action in the business enterprise.[8]

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[6] James L. Pierce, "The Planning and Control Concept," The Controller, Vol. XXII, No. 9 (September, 1954), pp. 403-404.

[7] Sord and Welsch, p. 49.

[8] Koontz and O'Donnell, pp. 429-440.

It is the budget making process in the area of planning that is pertinent to this paper.

The word budget has in recent years become closely associated with government spending. It must be pointed out that there is a fundamental difference between governmental and business budgeting, namely, that governments first estimate for expenses and then raise taxes or go into debt to cover them, while businesses must first estimate their probable income, or available finances, and then determine their most effective allocation and use in operating the business. While getting money is not usually a formidable problem to governments, it is usually the most pressing problem of any business, even the large and prosperous ones. An expense for a business that is not going to be ultimately a source of profitable income has to be avoided, and an expense that is not within the limit of actual funds available is just physically impossible.[9]

Budgeting is one of the best tools yet devised for the integration of plans. The budgeting process provides for expression of objectives and plans for each unit of the business organization. Through budgeting, plans are coordinated and attention is focused on objectives. It provides for balance, coordination and consolidation of separate plans into a master plan of action.[10] Sord and Welsch provide the following fundamentals for planning:

1. Objectives and planned programs must be carefully drawn.

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[9]Walter Rautenstrauch and Raymond Villers, Budgetary Control (New York: Funk and Wagnalls Company, 1950), p. 4.

[10]Sord and Welsch, p. 48.

a. General objectives must be definitely determined.

b. Specific objectives for specific periods of time must be definitely determined.

2. Plans should differentiate between long-term goals and shorter-run or immediate objectives, and recognize the nature of such differences.

3. Short-range plans should contribute to long-range plans.

4. Plans should be clear and comprehensive, yet as simple as is possible under the circumstances.

5. Plans should be formalized to be effective.

6. Plans should specify how, when, and by whom the plan is to be executed.

7. Plans should provide a standard for good performance.

8. Plans should be flexible.

9. Plans and objectives should be developed through participation by those responsible for their attainment.

10. Plans should have the basic objective of being constructive rather than restrictive.

11. Plans should be expressed in terms best suited to their attainment, which might be physical volumes, people, or equipment, but should be converted into financial terms where possible.[11]

In the planning phase of the budget process actions are proposed, opposing points of view are resolved, and a consistent course of action is set. Conditions expected are appraised and proposed actions to meet these

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[11] Ibid., pp. 47-48.

conditions are devised. Thus planning determines the actions that need to be taken and stimulates thinking ahead about those actions.[12]

James L. Pierce provides an excellent summarization of the meaning of planning as it relates to budgetary control:

> . . . planning refers to the predetermination of a course of action in such detail that every responsible unit of the company may be guided thereby. It includes sales forecasting, production scheduling, expense budgeting, and estimating manufacturing costs and inventory levels. It involves making advance decisions concerning new product development and introduction, merchandising methods, material procurement, and labor rates. In short, planning implies anticipating all the knotty problems to be met by a business during the planning period -- usually a year so far as operations are concerned, longer for financial and developmental activities -- in other words, facing the problems and making decisions about them ahead of time . . . .[13]

## Sales Forecasting

Most business executives and authorities on management practices make a distinction between forecasting and planning. One business executive has likened business forecasting to the activities of a man in courtship:

> While he is pursuing the lady of his choice, a man keeps a sharp eye open for other girls. He can change speed and direction rather quickly or even stop running if conditions change.
>
> Budgets on the other hand, are to business what an engagement is to a man. The scouting and pursuit are over, the plans are set, and the engagement determines rather definitely whom the man will marry, where, when, and how. Society does not encourage us to change these rather fixed plans. Similarly, after the goal of a business has been set, the budget programs, where, when, and how it will be achieved.[14]

Business forecasting is generally divided into two categories; the

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[12] Arnold F. Emch, "Control Means Action," Harvard Business Review, Vol. XXXII, No. 4 (July-August 1954), pp. 92-98.

[13] Pierce, "The Budget Comes of Age," p. 60.

[14] J.J. Curran, Jr., "Coordinating Budgets with Forecasting," Charting the Company's Future (New York: American Management Association, 1954), p. 32.

general economic forecasts and more specific forecasts which are limited to an industry, or to a particular company or product within an industry.

The forecasts of general economic conditions are usually performed by the government bureaus, such as the Department of Commerce, Federal Reserve Board, large corporation economists, and educational institutions.

Sales forecasting fits into the latter category. It operates in a far narrower field than the economists'. Sales forecasting is typically concerned with the outlook of a single individual company within that industry.[15] The retail merchandising industry, especially the chain store organization, is adaptable to even further refinement -- the expectation of a single store or department.

Since a sales forecast ordinarily considers a far smaller number of forces or influences than the economy must weigh, the sales forecaster can make forecasts which are often relatively accurate.[16] One retail organization, doing more than a billion dollars a year in business, demands and gets accuracy within two to four per cent. Companies have varying standards for accuracy and a ten per cent deviation of actual from forecast is average acceptability but individual companies may demand accuracy from one to twenty-five per cent.[17] Because budgets are developed around the sales forecast, a reasonably accurate forecast is a prerequisite to effective

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[15] Richard R. Crisp, "Objectives and Techniques of Sales Forecasting," Sales Forecasting: Uses, Techniques, and Trends (New York: American Management Association, 1956), p. 20.

[16] Ibid., p. 21.

[17] Lydia Strong, "Survey of Sales-Forecasting Practices," Sales Forecasting: Uses, Techniques, and Trends (New York: American Management Association, 1956), p. 149.

budgetary control. One very comprehensive survey revealed that one hundred per cent of the wholesale and retail companies reporting prepared sales forecasts. This high percentage attests the importance which the merchandising industry places on forecasting.[18]

Sales forecasting has many facets. It can be done at top-management levels and passed down to the operating levels as sales quotas. Or they can be prepared at the operating levels and passed up through the chain of command getting the necessary approval at each level as it works its way up to the top level. Sales forecasts are long-term and short-term. Long-term forecasts are made principally to serve the capital outlay area.[19] Short-term forecasts are used in budget preparation, manpower planning, earnings forecasts, inventory planning, and equipment and facilities planning.

The merchandising industry is a multi-product service, it provides to its consumers an endless variety of products and services. Thus each dollar of sales will not bring the same amount of profit; some sales are more profitable than others. Therefore, in addition to the total sales forecast, a forecast of the sales-mixture is an essential part of this phase of planning. The difference in profit margins among the various classes of merchandise sold is such that sales mixture can be the key to success or failure. A substantially unfavorable change in the sales mixture leads to a corresponding change in profits and may even lead to a loss even

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[18] Sord and Welsch, p. 135.

[19] John A. Howard, "A Note on Corporate Forecasting Practices," Journal of Business, Vol. XXVII, No. 1 (January, 1954)(University of Chicago).

though the total amount of sales is equal to or greater than the forecasted sales.[20]

While each company will generally have a forecasting procedure peculiarly adaptive to its own needs, resources, and organization, there seems to be four fundamental elements in the process regardless of the type or purpose of the forecast. One management consultant, prominent in the merchandising industry, provides the following four essential elements:

1. Developing the groundwork -- carrying out an orderly investigation of products, company, and industry, in order to determine generally how each of these has progressed in the past, separately and in relation to each other. In short the aim is to build a structure on which future estimates can be based.

2. Estimating future business -- following a clear-cut plan for working out future expectancies in the form of a mutual undertaking with key executives and, after future business has been estimated in accordance with the predetermined step by step procedure, issuing an official statement of the resultant forecast. The key executives, by mutually developing the forecast, automatically assume co-responsibility and individual accountability for such later deviations of actual from estimated results as may occur.

3. Comparing actual with estimated results -- checking the attained with the anticipated status of the business periodically, and tracking down reasons for measuring unanticipated gains or losses. Once measured, the reasons for important variations can be investigated on the spot.

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[20] Rautenstrauch and Villers, p. 156.

4. Refining the forecast -- once familiarity with estimating the future of the business is gained through practice, sharpening the approach and refining the procedure.[21]

Developing Short-Range Plans and Profit Objectives

Developing short-range plans and profit objectives is one of the basic functions of management. In a sound profit planning program, key forecasts provide the basis for operating plans. Operating plans, when translated and coordinated into budgets, tie directly into the pro forma balance sheet and profit and loss statement. These forecast financial statements provide the information for financial planning and the financial requirements in turn react upon the key forecasts and plans.[22]

James L. Pierce has defined budgets as plans of operations stated in the language of figures. He also describes budgeting as philosophy of communication, a constant look at the future, an indispensable preliminary to control and first essential of the incessant cost reduction effort without which competitive industry could not survive.[23] Some executives and authors dislike the term "budget" because it implies inflexibility; however, for the purpose of this study the budgetary concept will be the primary concern.

The development of a realistic budget is a tremendous task requiring careful specification of duties and time schedules. Most authorities are in accord that the budget program, to be effective, must have the whole-hearted support of top management. While the chief executive

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[21] J.S. Redfield, "Elements of Forecasting," Harvard Business Review, Vol. XXIX, No. 6 (Nov.-Dec., 1951), pp. 88-91.

[22] W.T. Seney, "Profit Planning for the Operating Man," The Controller, Vol. XXII, No. 5 (May 1954), pp. 211-212.

[23] Pierce, "Control by Budget," p. 327.

has the ultimate responsibility for the budget program, it is usually necessary that the supervisory responsibility connected with coordination be delegated to the controller or budget director. However, responsibility for developing the detailed plans and objectives should be definitely assigned to the respective executives responsible for achievement and not to the controller or budget director. The function of the latter in this phase of planning should be to design the system, supervise its operation, and provide staff assistance and constructive appraisal to the responsible executives.[24] This is the starting point for sound budget practice -- the placing of responsibility for making the budget.[25]

The survey of management planning and control practices conducted by Sord and Welsch indicated common patterns of participation in developing the budget: first, that many lower-level supervisors participate in planning by actively developing or reviewing plans for the area supervised; second, that a successive screening and coordinating of plans occurs at each higher level of management prior to approval by top management; third, that generally one individual assumes responsibility for consolidation of all plans into a master plan of operations; and fourth, that top management finally coordinates and approves the over-all program and formulates general planning objectives.[26]

This survey also revealed that in none of the companies participating were goals and objectives established exclusively by members of higher

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[24]Sord and Welsch, p. 92.

[25]Pierce, "Control by Budget," p. 330.

[26]Sord and Welsch, p. 93.

management without consultation with subordinate levels. In most of the companies, subordinate levels were requested to submit goals and objectives relating to their particular function for review and final approval by higher levels of management. In a few companies, goals and objectives were developed by higher levels of management and presented to subordinate levels for their consideration and comment prior to final approval.[27]

There are many and substantial values of a high degree of participation in planning. The screening at successively higher levels provides an excellent opportunity for two-way communication. The review of a subordinate's goals and objectives provides an excellent opportunity for constructive direction and training of a subordinate in addition to the training of the subordinate inherent in the development of the goals. There is usually a two-directional exchange of ideas and discussion of problems which is extremely beneficial to both parties.[28]

Wide participation also results in better planning since lower levels of management which actively participate in developing goals and objectives are intimately acquainted with the problems and methods of execution while the higher levels of management who screen plans are usually more intimately acquainted with problems of coordination and balance. Aside from better planning, the psychological values are the real values of a high degree of participation. It is conducive to better morale and greater initiative.[29]

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[27] Ibid., p. 95.

[28] Ibid., p. 97.

[29] Ibid., pp. 97-98.

Getting acceptance of budgets is a crucial problem for management and controllers will generally agree that having the supervisors all participate in the making of the budgets that affect them is the best way to gain acceptance of the budget.

Chris Argyris has written that participation, in the real sense of the word, also involves a group decision which leads the group to accept or reject something new. While all employees cannot participate in all phases of the budget and the over-all goals cannot be set in this manner, the ways in which these goals are to be accomplished can be decided upon cooperatively by interested employees. If top management has set down a goal there is not much sense in saying the supervisors or employees actually participated in setting that goal, nor should top management try to get them to feel this is <u>their</u> goal in the sense that they created it. However, top management can try to make them feel that this is their goal in the sense that they participated in the decision to accept it.[30]

While the over-all budget of the company is ordinarily regarded as the company's short-range financial plan, there may also be subsidiary short-range plans correlated, of course, with the over-all budget. These budget levels should always represent actual plans of operations. The sales budget should express a planned level of volume. Cost and expense budgets should reflect amounts required to carry out a carefully constructed plan of selling, warehousing, promotion, and administration. Peculiar to the retail industry is the open-to-buy plan which is a combination of inventory, purchasing, and sales budgets. The cash budget is based on the

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[30] Chris Argyris, "Human Problems with Budgets," <u>Harvard Business Review</u>, Vol. XXXI, No. 1 (January-February, 1953), pp. 97-110.

complete budget program. Stated in simple terms, the cash budget is a plan which tells management where the cash will come from and where it will be used.[31] The correlation of these levels is always to planning. The planned levels are those that the company's best efforts may be expected to produce. They do not represent easily attained minimum standards, nor are they ephemeral goals. The plan is an objective that all who accept it can conscientiously commit themselves to meet by full use of their energies. It should be difficult enough to challenge but not so difficult as to discourage. It should be based on pre-thinking so detailed and thorough that the organization knows, unit by unit, the steps it must take and the quality of performance it must display in order to fulfill it.[32]

## Long-Range Planning

Long-range planning has been described as the one really new technique left to management that can give a company a major competitive advantage.[33] One executive has emphasized its importance as follows:

> Decisions regarding short-term operations cannot properly be made unless the management of the company has made long-term plans for the future growth and development of the company. There are altogether too many instances where our current operations are being seriously affected because no one gave thought to the future of the company, and decisions were made on a short-term day-to-day exigency basis.[34]

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[31] Robert I. Phemister, "Forecasting of Cash," A Program of Financial Planning and Controls: The Monsanto Chemical Company (New York: American Management Association, 1953), p. 13.

[32] Pierce, "Control by Budget," p. 328.

[33] Bruce Payne, "Steps in Long-Range Planning, "Harvard Business Review, Vol. XXXVI, No. 2 (March-April, 1957), p. 95.

[34] John M. Thompson, "The Operating Budget," The Controller, Vol.XXIV, No. 7 (July, 1956), p. 312.

Sord and Welsch, in their survey of business budgeting practices, reported that eighty-one per cent of the retail and wholesale companies replying (16) utilize long-range plans for sales and capital expenditures. Seventy-five per cent of these companies make long-range plans for cash and profit while long-range plans for expenses are used in only thirty-seven per cent of the companies. Their survey also indicated that there is a correlation between the size of the company and the use of long-range plans -- company growth seems to indicate an increasing need for long-range plans.[35]

While short-range and long-range plans are not normally developed in isolation of each other, it is the practice of some companies to separate the development of these plans. The purpose of this separation is to develop better long-range plans. When discussed simultaneously, there may be an inclination to give insufficient attention to long-range plans.[36] However, there is generally a close relationship between short-range and long-range plans. The short-range plans are usually developed within the long-range objectives and the long-range plans are reviewed and revised to reflect the trends revealed in the short-range plans.

One executive has provided ten steps to effective long-range planning. These steps appear to be a comprehensive summary of principles generally advocated by scholars of the subject:

1. Analyze and project all segments of the economy for five or ten years into the future. This establishes the environment within which the company will operate.

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[35] Sord and Welsch, p. 128.

2. Project the company's market and anticipated business environment within the framework of the projected economy.

3. Set the company's goals and objectives within the framework of anticipated economic conditions and operating environment.

4. Formalize the first three steps and adopt them as company policy.

5. Develop a comprehensive marketing plan designed to achieve the company's sales goals.

6. Develop long-range plans for the other functions using the marketing plan as a base and consistent with the company's goals and objectives.

7. Consolidate plans of all functions, develop profits and capital requirements, and test the plan for reasonableness.

8. Formalize the long-range plan and specify the responsibilities of each function.

9. Develop the annual plan to accomplish the first segment of the long-range plan and use the long-range plan as a guide in developing subsequent short-range plans.

10. The final step is scheduled periodic review and revision of the plan. This should be done at least annually and then extend the plan for another year.[37]

Another writer has made the following pertinent comment relating to plans:

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[37]Archie R. Boe, "Long-Range Planning: The Key to Success," Business Budgeting, Vol. IX, No. 1 (September 1960), pp. 7-10.

> Plans alone cannot make an enterprise successful. Action is required; the enterprise must operate. Plans can, however, focus action on purposes. They can forecast which actions will tend toward the ultimate objective of economic efficiency, which tend away, which will likely offset one another, and which are merely irrelevant. Managerial planning attempts to achieve a consistent, coordinated structure of operations focused on desired ends. Without plans, action must become merely random activity, producing nothing but chaos.[38]

Financial Planning in the Navy Exchange System

Short-term financial planning has become a routine for management at all levels in the Navy Exchange System. The short-term planning procedure has been standardized throughout the world-wide network of exchanges; the objectives of the short-term plans have been set in explicit and detailed form; plans are developed, submitted, reviewed, revised as necessary, and approved on a scheduled basis. Over-all performance standards have been established for the system; the plans include all of the essential elements of exchange operations such as sales forecasting, expense budgeting, inventory control, capital expenditure budgets, cash flow forecasts, and profit plans. Short-range plans are developed and approved in light of the objectives and goals of longer-range plans and the service-wide operating requirements of the Navy Exchange System.[39]

The long-term planning is done at the top management level of the Navy Exchange System. This planning reflects the goals of the Chief of Naval Personnel and Chief, Bureau of Supplies and Accounts, in implementing

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[38] Billy E. Goetz, Management Planning and Control (New York: McGraw-Hill Book Company, 1949), p. 63.

[39] Financial Management, an outline of notes in the files of the Navy Ship's Store Office from the Navy Exchange Management Seminar, March, 1960, p. 1. (Mimeographed).

the welfare and recreation programs for naval personnel and maintaining a sound financial structure for the system. It considers the operational requirements to accomplish these goals and the feasibility of the goals and operating requirements. The long-range plans, further, must give consideration to the recommendations of the advisory committee.[40]

## Long-Range Plans

A formalized long-range master plan for the system was not made available to the writer; the existence of a "master" plan integrating the long-range administrative and financial plans was neither confirmed nor denied by the persons interviewed. However, pro forma balance sheets for a projected five year period are maintained and revised annually based on the past year's actual performance.[41] The frequent references to long-range requirements in conversation and notes would indicate that long-range planning is one of the essential functions of top management, whether or not these plans are formalized. A review of the agenda for the advisory committee meeting on May 14, 1954, indicates that at that time a formalized long-range plan was not used since specific long-range programs were proposed to the advisory committee in this agenda rather than through the media of a formalized plan.[42]

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[40] Ibid.

[41] Interview with Mr. L. Cattani, Operations Control, Fiscal and Reports Branch, Controller Division, U.S. Navy Ship's Store Office, March 29, 1961.

[42] Agenda for Advisory Committee Meeting, May 14, 1954, in the files of the Bureau of Supplies and Accounts Library.

## Short-Range Plans

Budgetary control is based on sound operating plans. These plans are usually developed for a period of one year or less and it is these plans that are emphasized by budgeting executives for management efficiency and control to achieve profit goals. Planning has been made the foundation for operating control of the Navy Exchange System.

### Planning at the Navy Exchange Level.

At the operating level, financial plans are developed and formalized in two basic forms: (1) the operating forecast; and (2) the open-to-buy plan. These plans when reviewed and approved by the Navy Ship's Store Office become the operating budgets of the individual exchanges. Over-all performance standards have been developed as goals, but the plans are developed at the exchange level. Each segment of the plan is reviewed by a technical specialist in the operating control branches of the Navy Ship's Store Office and again by the controller. The plan becomes a budget only after approval and review at each of these management levels.

### The Operating Forecast.

The navy exchange officer is responsible for the preparation of an operating forecast for the main and each branch exchange under his direction. The forecasts are prepared on a monthly basis and submitted to the Navy Ship's Store Office five months in advance of the month for which the forecast is prepared.[43] When the review reveals significant variances from

[43] *Navy Exchange Manual*, para. 2515.

standards or appear unrealistic in view of past performance or for other reasons, these variances become a matter for discussion with the navy exchange officer concerned. In addition, the navy exchange officer has the opportunity and responsibility to request revisions in the forecasts whenever it becomes evident that significant deviations from the original forecast are inevitable.

Sales, inventories, expenses, and profits are planned on both a departmental and total basis for the exchange in the operating forecast. In addition, the planned number of employees are shown for the retail departments as a whole, for the individual service departments, and for the administration of the exchange. The forecast also includes the actual results for the same month of the last year.[44] Thus the operating forecast provides a comprehensive financial picture of the individual exchange and its planned progress in regard to sales volume, operating efficiency, and profits.

Open-to-Buy Plan.

Since orders for merchandise are normally placed a month or two, and sometimes six months, in advance of the actual receipt of the goods, it is obvious that a plan is necessary to insure that there will be adequate funds available to pay for these goods when they are received and payment becomes due. "Open-to-buy" refers to the amount of money that is available for the procurement of merchandise planned to be received during a specific month.[45]

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[44] For a detailed description and illustration of the Operating Forecast, see Navy Exchange Manual, pp. 2-36-1 and 2-36-2.

[45] Ibid., para. 4122-2 .

The open-to-buy plan also provides for an orderly flow of merchandise into the exchanges from producers and distributors and is a basic financial control to maintain optimal stock balances to accommodate patron demands.

This plan provides for a statement of planned monthly sales, beginning of the month inventories, stock-sales ratios, and significant revisions to previously submitted plans on a retail department breakdown. The open-to-buy plan is prepared monthly for the sixth month in advance of the month in which it is prepared and is submitted to the Navy Ship's Store Office for review and approval. The plan may be revised or approved as it conforms generally to the standards of the system.[46] The plan as revised and approved is returned to the individual exchange where it becomes a control record to assure that an assortment of merchandise is available to the store which is balanced to customer demand, available funds, and a required departmental profit in consonance with the mission of the exchange.[47]

## Financial Planning at the Navy Ship's Store Office

It is apparent that a world-wide business organization which receives and disburses millions of dollars each month requires an operating plan which is projected further than the five months of the operating forecasts. Thus, the short-term financial plans or budgets are developed on an annual basis. These plans are developed on the basis of over-all system performance in the past, current trends in sales volume, expenses, and profits, economic

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[46] Ibid.

[47] Ibid., para. 4121.

conditions, and manpower levels and projections.[48] These plans also consider the long-range programs and the service-wide requirements of the Navy Exchange System.[49]

The annual financial plan of the Navy Exchange System is a combination of annual budgets which include an annual world-wide plan of operations by months; world-wide merchandise plans by departments; annual pro forma balance sheets; an annual plan of sources and application of funds; planned balance sheet ratios; an operating budget for the central office, Navy Ship's Store Office which divides operating expenses from service expenses for the navy exchanges; and monthly cash flow forecasts. These statements are put together in a "fact book" which includes audited balance sheets, operating statements, analysis of reserve funds, and a profit reconciliation for the past year. This "fact book" or financial plan is the guide used by top management in the decision making process. For top management at the Navy Ship's Store Office, it is up-dated each month as actual performance statistics are tabulated. Revisions to the original plans are stated as current projections for the remainder of the year based on the actual performance to date, and in relation to the planned figures and actual performance for the last year.[50]

Operating forecasts received from the individual navy exchanges are integrated into an over-all forecast and compared with the annual plans of the Navy Ship's Store Office; experience in these comparisons has revealed only insignificant variations.[51] Thus, it seems that the development of these

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[48] Interview with Mr. Ted Blume, Financial and Budget Analyst, U.S. Navy Ship's Store Office, March 29, 1961.

[49] Management Seminar Notes, March 1960, p. 1. (Mimeographed).

[50] Interview with Mr. Ted Blume, N.S.S.O., March 29, 1961.

[51] _Ibid_.

plans independently of each other serves as good measure of the validity of the planned premises used at both management levels.

The review of the operating forecasts at the Navy Ship's Store Office is another means of assuring that adequate profits will be available for the welfare and recreation programs of naval personnel and that adequate funds will be available to meet the budget requirements of the central office. The review of actual against planned performance in the operating forecasts indicated that individual exchanges may have variances as high as ten per cent for sales volume and/or profits; however, the variance for the over-all system is generally less than five per cent.[52]

The financial plan is thus developed and reviewed in light of the most pertinent information available to management. It is developed on historical financial facts and definite trends within the system; it is reviewed in comparison with planned estimates made at the operating levels; actual performance is measured against the plan; revisions to the plan are made through projections thus the original planned objectives are always in sight and not subject to so many changes as to destroy their validity; and finally, decisions are made based on significant deviations from plans and timely corrective action is taken to control problems and prevent them from becoming major financial difficulties. The financial plan is the heart of the Navy Exchange System operating controls.[53] It is a much used tool of top management in the day-to-day decision making process and it is presented

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[52] Interview with Mr. Milton Stupler, Budget Analyst, U.S. Navy Ship's Store Office, March 29, 1961.

[53] Interview with Captain D.G. Cone, SC, USN, Executive Officer, U.S. Navy Ship's Store Office, March 29, 1961.

to the advisory committee on a quarterly basis to keep them appraised of the financial condition of the system and provide them with sound premises upon which to develop recommendations at their semi-annual meetings.[54]

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[54] Interview with Mr. L. Cattani, N.S.S.O., March 29, 1961.

## CHAPTER V

## CONTROL BY BUDGET

It must be realized that a good business budget will set realistic levels for sales volume and reasonable goals for expenditures. The budget is not a control in itself; it is a guide for control, and it is an aid to the judgment of management, not a substitute for it.[1] Within reasonable limits of accuracy, the actual performance of the business enterprise must follow the patterns of the budget or the patterns must be changed. This means control and adjustment; control of the performance in any case, and adjustment to the budget if it is required.[2]

Without control the budget would be a simple recommendation aiming at more or less clearly defined goals; without adjustment, the budget could easily become a meaningless overexpanded plan or, on the contrary, could be turned into a strait-jacket threatening the growth of the business. With reasonable control and realistic adjustment procedures, the budget can and should be a real and effective tool of management, a flexible and yet well-defined, solidly established frame of reference, a reliable and trusted guiding pattern.[3]

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[1]Delbert J. Duncan and Charles F. Phillips, Retailing Principles and Methods, (Chicago, Illinois: Richard D. Irwin, Inc., 1951), p. 627.

[2]Villers and Rautenstrauch, p. 155.

[3]*Ibid*., p. 156.

## Control Defined

Control is one phase of a continuous management cycle which consists of planning, executing, and controlling. Planning precedes execution and establishes the foundation for effective coordination of effort. Control is the evaluation of results which becomes the basis for corrective action.[4]

One executive has stated this conception of control in the following simple and concise statement, "The essence of control is action which adjusts operations to predetermined standards, and its basis is information in the hands of manager."[5]

Once execution of the organization's plans has begun, continuous evaluation of performance is required at all management levels. Efforts must be consistently directed toward the organization goals. If objectives are to be achieved, performance must equal or better the planned performance, unless the fundamental conditions and assumptions on which the plans were based have changed materially. Information relating to current performance is necessary to detect and correct unsatisfactory performance. The extent to which plans are being carried out and objectives achieved must be ascertained by management, and when necessary, plans must be modified or completely changed to improve performance. The basis for corrective action is a periodic comparison of actual performance against performance standards. Control, then, is essentially the process of comparing actual performance against planned performance, of investigating significant deviations,

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[4]Sord and Welsch, p. 49.

[5]Douglas S. Sherwin, "The Meaning of Control," Dun's Review and Modern Industry (January, 1956), p. 46.

providing direction, and taking corrective action. The principle objective of control, as stated by Sord and Welsch, is to insure satisfactory performance by continually striving to locate unsatisfactory performance and taking timely action to correct and improve such performance.[6]

In their design of the basic functions of management, Sord and Welsch have listed the following functions of control:

1. Observing, recording, and reporting actual performance.

2. Comparison of actual with planned performance -- standards, budgets, plans and/or objectives.

3. Estimation of future performance.

4. Corrective action --

   a. Investigation and analyses

   b. Taking corrective action

   c. Follow-up to determine adequacy of investigation and effect of corrective action.[7]

Arnold F. Emch does not take exception to this concept of control; however, he emphasizes that these functions must be built into the organization structure as part and parcel of the responsibilities and authorities of every key position. He states that they should not be segregated and put on a list of functions under the heading "control." Control should be related to the specific responsibilities and authorities of each executive position -- it is then an integral element of every function,

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[6] Sord and Welsch, pp. 48-49.

[7] Sord and Welsch, p. 46.

and every function will then be truly under control.[8]

## Prerequisites to Budgetary Control

### Planning

The importance of realistic planning has already been discussed. At this point, it should suffice to state that realistic plans are the foundation of effective control.

A second prerequisite to control is a thorough understanding of the meaning and uses of control by the people who are being controlled. If these people understand control, are trained and conditioned for it, they will not resent it nor be awed by it. They will turn control to the constructive use for which it is intended, and it will become an aid rather than an obstacle.[9]

### Organization

Another essential prerequisite is clear-cut organization lines and the disposition to delegate authority along with responsibility.[10] Organization arrangements must give necessary and coordinated authority to subordinates who are expected to accomplish a task. When authority relationships are obscure or when a person does not have the power to do a given job, or does not know that he has the authority, then plans almost surely fail of execution and the next higher level of management has only

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[8] Emch, pp. 94-95.

[9] Pierce, "The Budget Comes of Age," p. 61.

[10] Ibid., p. 65.

itself to blame for the failure.[11]

Accounting System

Next, a system of records which establishes accountability and which is tailored to the budget program must be considered as a prerequisite to control. The use of accounting and statistical data is the means by which a business executive is able to direct and control operations which are beyond the range of his own personal observation and supervision.[12] An accounting system which has been designed to serve management control will tell management how far it has progressed in attaining its goals and where it stands. It is the basis for reliable reports to management.

Standards of Performance

A measure of what constitutes satisfactory performance is a necessary prerequisite to evaluation of actual performance. Satisfactory performance is usually expressed in terms of standards. Standards, in turn, should be expressed in measurable units such as time, manpower, materials, or money. Standards and control should be established for each subdivision of the organization.[13] One writer states:

> Sound planning and control require the determination and selling down of appropriate standards of performance in respect of the various activities or operations of the enterprise: These are to be determined by systematic analysis and assessment of the relevant facts.[14]

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[11] Sord and Welsch, p. 333 .

[12] J. Brooks Heckert and James D. Willson, Controllership: The Work of the Accounting Executive (New York: The Ronald Press Company, 1952), pp. 5-17.

[13] Sord and Welsch, p. 333 .

[14] E.F.L. Brech, Editor, The Principles and Practices of Management (London: Longmans, Green and Co., 1953), p. 41 .

The necessity of incorporating standards into budget plans is self-evident. Realistic standards are emphasized by Welsch in the following comment:

> Objectives should represent goals which are reasonably attainable and yet present a real challenge. Goals set so high as to be, for all practical purposes, impossible of attainment tend to discourage any serious effort to attain them. On the other hand, goals set so low that they call forth no special-effort will have no meaning or incentive for supervisors.[15]

## Reports

The factual background for the establishment or modification of policy and for the control of actual performance in line with standards and plans is communicated to management in the form of reports. The assembly of pertinent facts and their presentation in an orderly manner is thus a prerequisite to evaluation in the control process. The following concise definition seems to embody the principles of good control reports: "A good report may be defined as the communication in usuable form to a responsible party of timely factual data for a specific purpose." [16]

The report structure should be a coherent, understandable whole. It should represent an integrated plan of control under which the information given to all levels of management is tied together and becomes more condensed as it reaches higher levels of management. The reporting system should make it possible to follow information logically step by step from one report to another and from summary to supplementary or subsidiary reports. The well

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[15] Glen A. Welsch, Budgeting: Profit-Planning and Control (New York: Prentice-Hall, Inc., 1957), p. 29.

[16] Mason Smith, "Internal Reports," Corporate Treasurer's and Controller's Handbook, ed. Lillian Doris (New York: Prentice-Hall, Inc., 1950), p. 797.

designed structure of reports will provide each executive with: (1) the planning information necessary to make decisions for which he is responsible, and (2) the control information necessary to relate performance with planned goals covering the activities for which he is responsible.[17] The reporting system should make it possible for the executive to determine significant deviations readily, thus, facilitating the principle of management by exception.[18]

Sord and Welsch provide these requirements of a reporting system:

> Control reports must indicate individual responsibility for performance; therefore, such reports must follow precisely the organizational structure, related assignment of authority and responsibility, and reports are essential components of any effective control system.
>
> The frequency and detail of control reports vary with the level of management. At the lowest level of supervision frequent and detailed reports are needed for control purposes. At each successively higher level of management the need for detail decreases and the need for summarization increases. Top level management normally needs only highly condensed control reports. Regular reports are needed at all levels of management, but the need for frequent reports tend to diminish as the level of management becomes higher.
>
> Reports must also be timely, since the effectiveness of control is related to the time elapsed between the beginning of a significant variation and the correction of the causes of the variation. The longer an item is out of control, the greater the loss of efficiency. The earlier management receives signals that significant variations exist, the greater the effectiveness of any corrective action taken.[19]

In summary, the Industrial Accountant's Handbook has provided the following requirements of good management control reports:

1. Contain only essential information.

2. Provide appropriate data for various levels of management.

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[17] Phillip Gustafson, "Business Reports: How to Get Facts You Need," Nation's Business, Vol. XLIV, No. 8 (August 1956), p. 80.

[18] Sord and Welsch, p. 335.

[19] Ibid., pp. 335-336.

3. Provide for integration.

4. Reflect organization of the company.

5. Be designed for the user.

6. Use appropriate terminology.

7. Provide comparison with yardstick.

8. Account for out-of-line performance.

9. Show trends or tendencies.

10. Use comparable terms.

11. Segregate controllable from noncontrollable items.

12. Be issued promptly, regularly and at appropriate intervals.

13. Be neat, in logical order, and easy to handle.

14. Provide accurate information.

15. Be economical.[20]

## Evaluation in the Control Process

Evaluation of information is an essential phase of budgetary control. The degree of efficiency or inefficiency with which an assigned task is accomplished must be determined generally by comparing actual performance with planned performance. Sord and Welsch give the following steps in the evaluation process:

> First, it involves a comparison of planned performance with actual performance; second, if there have been deviations from planned performance, it involves a decision as to whether a particular deviation is significant or not; and third, if there have been significant deviations, it involves a decision concerning what action should be taken.[21]

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[20] Wyman P. Fiske and John A. Beckett, Editors, Industrial Accountant's Handbook (New York: Prentice-Hall, Inc., 1954), p. 1040 .

[21] Sord and Welsch, p. 334.

These authors continue:

> One difficulty in evaluating performance lies in deciding when a deviation is significant. Normally there will be fluctuations above and below standards of performance. Determination of the range of fluctuations to allow before they are considered significant is frequently difficult. A suitable range of insignificance will depend upon the type of business, and within a firm, on the department and item. Conditions existing at a particular time and the degree of control management wishes to exercise over a specific organization sub-division or item will usually determine the range that should be allowed. The established range should be critically reviewed periodically. Variations from standard should be expressed as an amount and as a percent of budget, or both.[22]

Corrective Action

Action is the essence of control -- budgets, reports, and appraisals do not constitute control and are not control in themselves. When action does not follow appraisal, subordinates become complacent and the budgetary program decays to a sterile procedure. Koontz and O'Donnell make the following statement concerning controls:

> A control system that detects failures or deviations from plans will be little more than interesting exercise if it does not show the way for needed corrective action. Thus, an adequate control system should not only detect failures but should disclose where they are occurring, who is responsible for them, and what should be done to correct them.[23]

Another writer has stated:

> Control is being exercised when the operations of the enterprise are guided within the plans adopted, are held in line in face of varying conditions, or are returned to an in-line state after deviations are located.[24]

Ralph C. Davis has divided corrective action into two principle phases, as follows:

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[22] Ibid., p. 337.

[23] Koontz and O'Donnell, p. 549.

[24] Emch, p. 97.

1. The operative phases

a. Prompt investigation of the cause of the deviation.

b. Decision concerning the required corrective action.

c. Prompt direction for correcting the situation in accordance with the decision.

d. Close supervision of corrective action to insure that it is taking place in accordance with instructions and is effective.

2. The administrative phases

a. Further investigation of recurring difficulties to determine the basic factors, either human or physical, that are responsible.

b. Disciplinary action, either positive or negative, as the situation requires.

c. Creative planning to prevent recurrence of the situation.

d. Reorganization of the situation and the introduction of the planned measures.[25]

Corrective action is taken through people and the results are achieved by people; therefore, it seems self-evident that understanding of controls and good working relationships must exist between the person controlling and the person or people being controlled in the action phase of control. Edmund F. Fitzmaurice has observed: "Mere delegation of responsibility is not enough. If it is to mean anything the person to whom it is delegated must accept the responsibility and be obliged for its performance."[26]

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[25] Ralph C. Davis, The Fundamentals of Top Management (New York: Harper and Brothers, Publishers, 1951), p. 731.

[26] Edmund F. Fitzmaurice, "The Essence of Control," The Controller, Vol. XVIII, No. 11 (November 1950), p. 494.

Pierce has advised: "Use your budget as a tool to be placed in your foremen's hands -- not as a club to be held over their heads." [27]

## Should Controllers Control?

Most writers on this subject seem to be in agreement that the controller's role in management is an advisory or staff function and that he should have no direct operating responsibilities, except for those that pertain to the operation of his own department.

Arnold F. Emch states:

> In fact, the more important and delicate tasks the controller must perform have to do with advising the president and other executives on the broad, over-all picture of the enterprise; coordinating basic plans and budgets; preparing and issuing special control reports; and standardizing methods of accounting and other procedures.[28]

In each of these responsibilities, the informational character is predominant. Even James L. Pierce, one of the most vociferous champions of controllers and controllership, advises:

> See that the controller and his staff express the correct attitude for the responsibility they undertake with respect to budgets. It is the controller's job to establish, maintain, and coordinate a budgetary system -- in fact, a complete system of planning and control. But this work must be accomplished through authorized management. He must not enforce his instructions nor issue orders. He and his staff must be devoted to producing, reporting, and interpreting information -- to making the planning and control machinery run. He is wholly a staff executive, and his only honors stem from the confidence of his associates. This he earns by honestly providing the control service and refraining from making operating decisions.[29]

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[27] Pierce, "The Budget Comes of Age," p. 65.

[28] Emch, p. 95 .

[29] Pierce, "The Budget Comes of Age," p. 65 .

## Scope of Control

Control permeates the entire organization hierarchy. The primary purposes of control are to evaluate actual performance in relation to standards of performance and to take corrective action when unsatisfactory performance is detected. Control extends from top management because responsibility for operation of the entire business enterprise rests there. Because some supervisors may fail to take adequate action to correct unsatisfactory performance, their next higher level of the organization must assume responsibility for unsatisfactory performance. Thus, each level of management must assume responsibility for controlling all of its subordinate units.[30]

Holden, Fish, and Smith, outlining the effective means of control, provide the following scope of control:

> Control over policies.
> Control over organization.
> Control over key personnel.
> Control over wages and salaries.
> Control over methods and manpower.
> Control over capital expenditures.
> Control over service department effort.
> Control over line of products.
> Control over research and development.
> Control over foreign operations.
> Control over external relations.
> Over-all control.[31]

They add, " . . . regardless of formal systems of control, there is no substitute for firsthand observation of conditions and for personal

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[30] Sord and Welsch, pp. 341-342.

[31] Holden, Fish, and Smith, pp. 8-11.

contact with people on the job."[32]

Thus, it is clearly evident that the scope of control covers the entire horizontal breadth of the organization structures and extends from the top of the organization down to the lowest level of operations, touching every operation, staff function, and person in the business enterprise.

## Summary

Budgetary control is one of the most useful control devices available to management for control. It is flexible enough to fit the needs of most business, yet it provides for control of every aspect of a business. It can be used to integrate all types of control for all levels of management into a master control system.[33]

Sord and Welsch summarize the essentials of managerial control as follows:

1. Clearly defined authority and responsibility.
2. Definite goals and objectives.
3. Sound standards of performance.
4. Adequate reports of actual performance.
5. Comparison of actual performance with standards of performance in terms of clearly defined authority and responsibility.
6. Analysis of deviations from performance.
7. Control action by responsible persons to correct unsatisfactory performance.

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[32] *Ibid*., p. 12.

[33] Sord and Welsch, p. 342.

8. Timely evaluation of performance.[34]

The scope of budgetary control and its depth make it apparent that control is not a function to be performed in isolation of the other enterprise functions, it is an integral part of each of them. Budgetary control to be truly effective, must become not only a policy of the organization but a philosophy or state of mind of the people employed in the organization.

## Internal Audit Control

Internal audit control is not generally considered to be an integral part of budgetary control; however, the internal audit process can be an essential aid to management in maintaining an effective budget program and in improving the methods and procedures of budgetary control.

The Institute of Internal Auditors, Inc., in 1947 gave the following definition of internal auditing:

> Internal auditing is the independent appraisal activity within an organization for the review of the accounting, financial, and other operations as a basis for protective and constructive service to management. It is a type of control which functions by measuring and evaluating the effectiveness of other types of control. It deals primarily with accounting and financial matters but it may also properly deal with matters of an operating nature.[35]

From this definition it is apparent that internal auditors are not limited in their scope to determining only the mathematical accuracy of figures in the company accounts, but are more concerned with making detailed appraisals of various company operations that are responsible for the figures

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[34] Ibid., p. 346.

[35] Statement of the Responsibilities of the Internal Auditor, quoted in Frank A. Lamperti and John B. Thurston, Internal Auditing for Management: The Relationship of Internal Auditing to Management Controls (New York: Prentice-Hall, Inc., 1953), p. 84 .

in these accounts. Internal auditing is essentially management auditing: it determines whether management at all levels has established proper safeguards to ensure that the company will receive full value for every dollar of expense incurred and if these safeguards, as expressed in terms of company policy and procedures are complied with by succeeding lower management levels.[36]

Internal auditing is an administrative device that can be used by top-management to expand the area of decision-making at the middle-management levels. Through audit surveillance, the central or home office can safeguard the exercise of delegated authority, thus top-management can increase the amount of responsibility that it can safely delegate. This is an especially important aspect of internal auditing in a highly decentralized organization.[37]

Lamperti and Thurston state that internal auditing ". . . rounds out all of the basic elements of management control and is in itself the main element of the appraisal, measurement, and evaluation control."[38] Internal auditing is the inspecting of management controls -- it has the function of continuously measuring and evaluating all other controls.[39] It challenges every feature examined, determining whether:

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[36]William T. Jerome III, "Internal Auditing as an Aid to Management," Harvard Business Review, Vol. XXXIII, No. 2 (March-April, 1953), p. 128.

[37]*Ibid*., p. 131.

[38]Lamperti and Thurston, p. 83.

[39]*Ibid*., p. 91.

1. It conforms with company policies.

2. Controls are adequate, effective, and efficient.

3. Accounting and operating procedures are proper.

4. External regulations are complied with.

5. All records are prepared and stored with adequate care.

6. Controls provide necessary safeguards against fraud, removing all sources of temptation as much as possible.[40]

The scope of internal auditing extends beyond budgetary control, indeed, its investigation of expenditures in relation to budgets, budgetary procedures, methods and management budget functions are only part of the total internal audit. However, a closer look at internal audit control will reveal that it is more than a police action as it relates to budgetary control. Budgetary controls will not in themselves eliminate inefficient work methods or unnecessary procedures; they do not generally act as a deterrent to dishonesty; they do not eliminate duplication of effort; and they generally cannot ensure compliance with company policies -- all of these practices can, in fact, be budgeted for; thus, internal audit control works hand in hand with budgetary control as means to accomplish prime objectives of a business organization: increasing profits and improving efficiency of operations.

## Financial Control in the Navy Exchange System

In the previous chapter it was established that the Navy Exchange System has developed comprehensive short-range planning procedures and plans

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[40] *Ibid.*, p. 90.

for sales, expenses, procurement of merchandise and equipment, cash flow, and profits. While a formalized long-range plan was not available to the writer it was evident that long-range planning is an essential function of top management and that pro forma balance sheets are developed for a projected five-year period as a basis for long-range financial planning.

Annual budgets are developed to provide for over-all control of the System. Both top management and operating levels participate in developing budgets for over-all and individual exchange operations on a five month basis and merchandise budgets are formulated to provide control over retail operations for a projected six-month period. In light of these plans, it appears that the Navy Exchange System can establish an adequate control system because the primary planning prerequisite of control has been met.

## Control and the Organization Structure

Management and technical control of the individual exchanges is exercised through the commanding officers of the activities at which the exchanges are located. The Navy Ship's Store Office is organized to provide essentially functional or product line control over the operations at exchange level. The organization also incorporates a regional control aspect; however, the purpose of regional divisions is to facilitate liaison with the exchanges and to coordinate the controlling action in the retail departments. Thus control is exercised essentially through the eight functional divisions of the Navy Ship's Store Office through the commanding officers to the exchange officer concerned.

At the operating level the exchange officer is responsible for exchange operations to the commanding officer of each activity where a main, branch, or location exchange may be located. If an officer assistant has been billeted to a branch exchange, the resident assistant navy exchange officer is similarly responsible to the navy exchange officer of the main exchange and to the commanding officer of the activity at which the branch exchange is located. Financial controls at this level are generally exercised through personal supervision and are facilitated by subsidiary operating control devices.

## Reports

Financial control is exercised primarily through approved operating forecasts and open-to-buy plans. The first step in the control process is the revision or approval of these plans by functional specialists of the Navy Ship's Store Office. Comparison of actual performance results against these plans and the evaluation of actual results by these specialists are further control steps. The evaluation of actual results provides the premises for decisions that corrective action is or is not required, and if required, what kind of action must be taken by the exchange officer concerned. Reports are the media for communicating the information developed in this process to the people who require the information to carry out their assigned duties.

The accounting system is the medium used to gather the financial statistics resulting from operations. At the Navy Ship's Store Office, six area groups of the accounting branch audit all documents from those stores within their area. Thus each area group handles the complete accounting

operation for all the stores for which it is responsible.[41] The accounting data is then tabulated into operating statements for each of the exchanges and for the over-all system. The operating statements provide for a comparison of actual performance results against both the planned figures and the last year's results. Variances of actual performance results from plans are computed on a percentage basis. The monthly operating statements for each exchange are sent monthly to the commanding officers and the navy exchange officers concerned. These statements are generally forwarded within twenty-five days after the end of the accounting month.[42]

The Navy Ship's Store Office functional specialists review significant variances and, based on their evaluation of actual results, originate Advisory Notices which contain the suggested corrective action that should be taken by the navy exchange officer concerned. These advisory notices generally require a reply from the navy exchange officer which contains his explanation of the variances and his intended course of action to correct the unsatisfactory aspects of his operations. A pattern of continuing significant discrepancies generally results in advisory type letters to the commanding officers concerned by the commanding officer, executive officer, or controller of the Navy Ship's Store Office.[43]

The reports, of course, also act as a feedback device to the planning process at all levels of management and become the basis for projections in the System Financial Plan.[44]

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[41] Navy Exchange Review, Vol. XIII, No. 11 (November 1960), p. 6.

[42] Interview with Mr. M. Stupler, N.S.S.O., March 29, 1961.

[43] Ibid.

[44] Interview with Mr. Ted Blume, N.S.S.O., March 29, 1961.

## Standards of Performance

The performance standards of the Navy Exchange System are perhaps best explained by an illustration of some of them in Table 1. In addition to the standards shown in Table 1, retail sales statistics have been computed to establish goals for sales volume mix of departmental sales by month for both continental and overseas exchanges and model stock composition of departments.[45] The service departments likewise have developed detailed operating standards for each operation within the individual departments.[46]

In the review and evaluation processes, both planned and actual results are compared against these standards and they must be considered by the exchange officer as he develops his plans. Generally these standards are not easily attained nor are they beyond realistic operating goals for most exchanges. Attainment of these performance standards is dependent upon the ability of exchange personnel, physical facilities and location of the exchange, economic conditions, and all of the other factors which tend to make one business enterprise more profitable and efficient than others.

## Corrective Action

Corrective action has been said to be the essence of control. The methods of taking corrective action varies not only among organizations,

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[45] Navy Exchange Manual, para. 4202-4283.

[46] Ibid., para. 4301-4383.

TABLE 1

PERFORMANCE STANDARDS FOR NAVY EXCHANGES[a]

Retail Departments

| Sales Volume Grouping | Gross Profit (%) | Maximum Payroll (%) | Maximum Total Direct Expense (%) | Minimum Net Department Contribution (%) |
|---|---|---|---|---|
| $ 0-10,000 | 14.0 | 3.4 | 4.0 | 10.0 |
| 10,001-35,000 | 14.5 | 3.4 | 4.0 | 10.5 |
| 35,001-80,000 | 15.2 | 3.2 | 3.8 | 11.4 |
| 80,001-150,000 | 15.8 | 3.2 | 3.8 | 12.0 |
| 150,001 and over | 16.5 | 3.0 | 3.6 | 12.9 |

Service Departments

| | Minimum Gross Profit (%) | Maximum Payroll (%) | Maximum Total Direct Expense (%) | Minimum Net Contribution (%) |
|---|---|---|---|---|
| Barber | 95 | 82 | 90 | 5 |
| Cobbler | 65 | 55 | 60 | 5 |
| Service Station | 20 | 8 | 9 | 11 |
| Tailor & Dry Cleaning | 60-90 | 45-75 | 50-80 | 10 |
| Food Service | 38 | 19 | 24 | 14 |
| Enlisted Men's Clubs (Continental) | 35 | 18 | 22 | 13 |
| Enlisted Men's Clubs (Overseas) | 37 | 16 | 20 | 17 |
| 1st & 2nd Class Petty Officers' Clubs | 45 | 20 | 25 | 20 |
| Laundry | 90 | 60 | 80 | 10 |
| Vending Machines | - | - | - | 15 |

General Expenses

| General Administrative Payroll | | Percent of Total Sales |
|---|---|---|
| Group I | Under $10,000 . . . . . . . . . . . . | 2.7 |
| Group II | $10,001-$35,000 . . . . . . . . . . . | 2.7 |
| Group III | $35,001-$80,000 . . . . . . . . . . . | 2.7 |
| Group IV | $80,001-$150,000 . . . . . . . . . . . | 2.5 |
| Group V | $150,001 and over . . . . . . . . . . . | 2.3 |
| Other General Expense | | |
| Continental | | Maximum 1.4 |
| Overseas | | Maximum 0.8 |

[a]*Navy Exchange Manual*, para. 2515-3.

groups and persons but will also vary to accommodate the circumstances which required the corrective action. The mechanism of taking corrective action involves a study of human relations beyond the scope of this paper. For the purpose of this study however, it has been established that timely corrective action is initiated at all levels of management in the Navy Exchange System and that corrective action is based upon evaluation and decisions relating to actual performance results, planning and performance standards.

## Internal Audit Control

The Field Services Division is the formal internal audit arm of the Navy Exchange System. The director of the Field Services Division reports directly to the commanding officer of the system. The responsibilities of his staff are not confined to verifying the accuracy of accounting and financial transactions. Their primary function is management analysis of individual exchanges. This includes review of operating statements; advisory visits; assistance in conducting surveys (inspections); follow-up on survey recommendations; review of military personnel allowances; preparation of statistical reports on a sales volume basis and maintaining inventory shortage control over the individual exchanges.[47] The field services staff thus is continually checking on compliance with system policies at the exchange level. The functional specialists also are constantly checking results of the exchanges which indicate compliance or deviation from established policies of the system. The combination of these

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[47] Navy Exchange Review, Vol. XIII, No. 11 (November 1960), p.6.

two staffs along with the controller's staff should certainly provide an effective means for determining not only the fidelity of exchange personnel but also whether or not policies are being followed and for testing the effectiveness of the established policies.

## Other Controls

The Navy Exchange System, like other business organizations, utilizes other controls which have a strong interrelationship with budgetary control. A lengthy discussion of each of these controls is not within the scope of this study; however, some of these controls are so strongly related to budgetary control that their mention is pertinent to this thesis.

It should suffice to state that a certain degree of control is exercised through personnel policies which are developed and promulgated by the Navy Ship's Store Office.

Price control is exercised through established mark-up percentages by department which are checked not only monthly but also by individual purchase order. Another aspect of price control is exercised through the use of the open-end contracts which the Navy Ship's Store Office negotiates with manufacturers. While exchange officers generally purchase all of the merchandise and supplies for their exchanges, they are encouraged to purchase from local sources only when they are able to obtain items of the same quality at equal or lower total cost from the local sources. It is the writer's opinion that approximately ninety per cent of all merchandise procured by continental exchanges is purchased from the open-end contracts. It is thus self-evident that not only the selling prices are controlled by the use of

these contracts but also the quality of the merchandise offered for sale.

Product-line control is primarily incorporated in the Armed Services Exchange Regulations which limits the items and services which may be offered by the exchanges as well as the cost price of most of the items. These controls are strong factors in the merchandise budgets as well as the over-all budgets of the exchanges and the system as a whole.

Store and service department layouts are generally subject to approval of the Navy Ship's Store Office and are further controlled to the extent that all equipment is procured by the office. This control is reflected in the capital expenditure budget.

The system thus utilizes most of the controls available to private enterprise and incorporates these controls into its budget program as well it must if the budget is to be effective and have meaning in its role toward accomplishing the mission of the system.

## Summary

The Navy Exchange System has been organized for the purpose of controlling the decentralized operations of a wide network of exchanges. Its goals and objectives are clearly defined and promulgated within the limits of practicability. The system has developed performance standards for every department and many of the more detailed operations within the individual exchanges. It has designed an accounting and reporting system to meet the specific needs of both management and operating levels of the system. Comparison of actual performance results with plans and performance standards are made regularly on a timely basis. Significant deviations are analyzed

and the analysis is the basis for decisions to take corrective action by those persons responsible for unsatisfactory performance. Finally, performance evaluation is a continuous process in the Navy Exchange System.

## CHAPTER VI

## CONCLUSIONS AND RECOMMENDATIONS

### Conclusions

Throughout this paper it is emphasized that the Navy Exchange System is a profit making organization. It is this profit-making aspect which makes the Navy Exchange System and its counterparts in the other armed services unique as business enterprises within the framework of government. Contrary to public opinion in this country that government business activities do not utilize the accepted principles and practices of business management and are, therefore, not so efficiently and effectively managed as private enterprises, it has been emphasized that the administrators of the Navy Exchange System are not only aware of these principles and practices of business budgeting, but do utilize them in every phase of its operations.

The Navy Exchange System is organized at each level to accomplish its assigned mission: (1) promoting morale of naval personnel; (2) providing convenient and reliable sources from which to purchase goods and services of common necessity at the lowest practical costs through efficiently managed exchanges; and (3) providing through profits, a source of funds to be used for the welfare and recreation of naval personnel. The exceptions noted to commonly accepted organization principles are: (1) that control must be exercised through commanding officers of the activities at which exchanges

are located and (2) that exchange officers are sometimes responsible to several commanding officers and to the Navy Ship's Store Office for performing their assigned duties.

The first exception is necessary and justified in light of the military command structure and the responsibilities of the commanding officers. However, at the operating level it would seem that control over branch and locations would constitute a dilemna for the exchange officer ranging from nightmare to fantasy. He is responsible to many "masters" and is expected to exercise operational control over activities sometimes spread over a wide geographical area. Responsibility up goes to individual commanding officers who can exercise authoritarian control over the exchange officer as well as the exchange operations if he so wishes. Each commanding officer is quite naturally interested primarily in maximizing the services of his exchange rather than optimal service and efficiency of operations for the complex as a whole.

Down,in the responsibility chain, the exchange officer in exercising control may journey for several hours to a branch or location exchange at least once each month, and probably more often, only to spend an hour or two talking to a sales clerk, whose ability may be graded at forty or fifty dollars per week, and trying to motivate this clerk enough to keep him going until his next visit. The exceptions of course would be the large branch exchanges with sales volume sufficient to support a high level of management. However, even where a capable management is available at the branch exchange, control for a concerted purpose will usually involve a conference between the commanding officer, executive officer, navy exchange officer, resident

assistant navy exchange officer, and sometimes the supply officer or administrative officer, if misunderstandings of purpose and method are to be avoided or if the branch level of management is to be prevented from playing one control source against another. Where location exchanges are under the direction of the branch exchange, the problem can become complex to an exponential power.

Another less significant exception to organization at the operating level is that warehouse operations are separated from the retail department even though most of the effort expended for and its primary function may be the servicing of the retail department. Since the service departments are selling essentially human effort, they require very little warehouse service -- it is safe to assume that less than ten per cent of the total warehouse effort is for service departments. It may be argued that the warehouse is required to service the retail stores of the branch and location exchanges and therefore must be separated from the main exchange retail department; however, the support of these exchanges can be incorporated into the responsibilities of the retail manager of the main exchange. Thus, the communication channels up to the exchange officer could be eliminated in achieving coordination of these two functions.

Another possible exception to business organization principles is that an advisory committee is used in place of a board of directors having formal authority and responsibility for the system. While the advisory committee is empowered to make only recommendations to the Secretary of the Navy, it has been implied that these recommendations generally carry all of the authority of a formal decision by a board. Further, the use of an advisory committee

allows the system to have the advantage of the experience and knowledge of successful executives from a variety of business fields. The use of the advisory committee and its "outside" members can also alleviate much of the political pressure and accusations that the system is administered by military officers and civil service type government officials who have no experience in retail merchandising or business finance.

Budgeting in the Navy Exchange System is designed to meet the service-wide requirements of the system and the needs of the individual exchanges. The budgeting practices and procedures are based on sound planning and a control system designed for efficient and effective use of finances and resources. Each business organization must develop its budgeting program to meet its specific needs otherwise budgeting could easily become an academic drill; the Navy Exchange System does not differ in this respect. While the system's budget program is adapted to its needs, its practices and procedures are in consonance with those advanced by budget authorities and utilized by most successful business organizations.

One significant exception in this area is that performance standards have been developed for the over-all system rather than being tailored to the individual exchanges. Since the exchanges are spread throughout the world, it is generally accepted that labor standards and costs will vary from one area to another, physical facilities are not standardized, and the nature of patronage will differ among naval activities even though they may be located in the same geographical area. Thus, these standards may provide desirable goals but they are not always realistic standards against which to measure actual performance.

A less significant exception at the operating level is that the retail department does not bear its full share of the expenses which it incurs. The expenses of warehouse operations and accounting are charged against general expense. Just as most of the effort of warehouse operations is expended to service the retail department, most of the documents processed and records kept at the exchange level result from retail operations. If, for example, the exchange is unfortunate in having inventory shortage problems, the amount of effort expended in the accounting department for retail operations is greatly increased but these costs are not reflected in the retail department's contribution. While this aspect of expense costing has no significance in the total operations profit of the exchange, the retail manager may find solace in achieving a net contribution in his operations which do not truly reflect all the costs incurred by his department -- he may, in fact, be operating at a loss if all the expenses he incurred were charged to his operations.

## Recommendations

It is recommended that --

1. If a formalized long-range plan is not already in existence, consideration be given to formulating such a plan. The long-range plan should translate the broad mission and goals of the system into specific programs, projects, and resource requirements, and assign responsibility for accomplishing these to specific organization units. Further, the long-range plan can establish a phased schedule for accomplishment consistent with the resources available within the prescribed legal and administrative limitations

on the system. It should, of course, provide for a systematic procedure for performance and progress evaluation. Whether the effort involved to formalize the long-range plans can be justified by the extent of their use must be a decision for top management. However, such formalized plans are in common use among large business organizations and it seems that its use could also be justified in the Navy Exchange System.

Business operations in the last decade have experienced some revolutionary changes which have had a strong impact on management. Employee insurance, hospitalization and retirement plans, automatic data processing, self-service merchandising are just a few of the recent developments which have left some managements at the starting gate or have had staggering effects on the financial stability of some enterprises. Such changes can reasonably be expected to continue and more likely develop at an even faster pace than heretofore. One possible program for a long-range plan might be standardizing the layout of stores such as the large variety store and supermarket chains have done. It should behoove an alert management team to anticipate these changes and plan for them so that they can be incorporated into the operations in a routine and orderly manner at a minimum cost in effort and money.

2. Branch and location exchanges be controlled by a resident subordinate of the commanding officer of the activities at which they are located; also, that logistical support in the form of supply of merchandise and equipment, transportation, accounting, and personnel and advisory service, when requested, be made one of the assigned missions of the main navy exchange. The branch and location exchanges are generally small operations located at activities which have a high concentration of civilian personnel in relation

to military personnel; it follows that these activities generally have a relatively high officer population. The commanding officer of the activity can designate one of his Supply Corps officers to act as navy exchange officer as a collateral duty. Generally, there are officers available who derive a great deal of satisfaction from this work and welcome the opportunity to gain experience in retailing. More effective control of these exchanges would be achieved through its consistency; the employees would not have the opportunity to play one control source against another; objectives would be less vulnerable to misunderstandings; and finally, but equally important, the employees would not be confused by divided loyalties and they would have an accessible and convenient source for guidance in solving their problems. It would seem that under the present system of organization, the exchange officer in his intermittent visits to the more remote exchanges has more of an inspector personality than manager to these employees.

3. Performance standards be developed for individual exchanges or for groups of exchanges that have more in common with each other than purely sales volume.[1]

4. The warehouse at the exchange level be incorporated as a separate unit of the retail department and that support of retail stores at branch and location exchanges be made a function of the retail manager of the main exchange.

5. The cost of warehouse operations be charged as a direct expense to

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[1]This concept was advanced by Captain R.W. Sauer, SC, USN, the former Commanding Officer, U.S. Navy Ship's Store Office, at the Management Seminar held there in March 1959 as one of the uses which would be made of the electronic computer then being installed at the Central Office. Commander A.E. Blank, SC, USN, Director of the Planning Division, in an interview on March 30, 1961, indicated that this was one of the long-range projects for the System.

the retail stores receiving its service. It would be impractical to charge the accounting expenses directly to the retail department because the accounting department serves as part of the control over the retail department. It would not be prudent to eliminate this element of control by making the accounting department a unit of the retail department nor would it be sound practice to charge the retail department with costs over which it has no control; however, the retail manager should be made aware in some less formal manner of the costs of accounting and that his operations are incurring a majority of these costs.

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